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SUPREME COURT, U.S.

No. [redacted]

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

132

LOUIS H. LEWIS AND ANNETTE LEWIS and ESTATE OF HYMAN FURST, Deceased, by LOUIS H. LEWIS, Executor,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Petitioners pray for the issuance of a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above entitled case.

OPINIONS BELOW.

The findings of fact and opinion of the Tax Court (A. 153-187) are unofficially reported in 21 T.C.M. 1647 (C.C.H.). The opinion of the Court of Appeals for the Seventh Circuit has not yet been officially reported. Both opinions are reprinted in the Appendix hereto.

JURISDICTION.

The judgment of the Court of Appeals was entered on March 2, 1964. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254.

STATUTES INVOLVED.

INTERNAL REVENUE CODE OF 1954:

SEC. 165. LOSSES

(a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business.

SEC. 63. TAXABLE INCOME DEFINED.

(a) GENERAL RULE.—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deduction allowed by this chapter, other than the standard deduction allowed by part IV (Sec. 141 and following).

SEC. 1234. OPTIONS TO BUY OR SELL.

(a) TREATMENT OF GAIN OR LOSS.—Gain or loss attributable to the sale or exchang· of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

STATEMENT OF FACTS.

The taxpayers in the proceedings below were Louis H. Lewis and Annette Lewis, his wife, who filed joint returns for the years in question, Hyman Furst, who died subsequent to the taxable years in question and who appeared through Louis H. Lewis, Executor of the Estate of Hyman Furst, and Samuel Pearl and Mary Pearl, who filed joint returns for the years in question. Samuel Pearl and Mary Pearl are not parties to this petition for writ of certiorari. The facts in the cases are identical except for the amounts involved. For convenience, all references hereinafter to the petitioner refer to Louis H. Lewis (his wife, Annette Lewis, is a party to these proceedings only by virtue of the fact that a joint return was filed). The facts relating to Louis H. Lewis are also applicable to the estate of Hyman Furst, deceased, except for differences in dollar amounts. (A. 146, 150, 154)

Early in 1955 petitioner was contacted by representatives of M. Eli Livingstone, a Boston stockbroker, who outlined to him a plan involving the purchase of large amounts of U. S. Government securities; the borrowing of all funds required to purchase such securities; the prepayment of interest on the loan and the subsequent sale of such securities in the next year. (A. 155-157) Petitioner investigated Livingstone and secured legal opinions with respect to the tax consequences of the proposed transaction. (A. 156-7, 188-204)

On November 22, 1955 petitioner purchased $1,000,000 United States Treasury 2-⅞% notes due March 15, 1957 with the March 15 and September 15, 1956 coupons detached at a total price of $975,000. (A. 158-9) Petitioner borrowed the entire purchase price from Corporate Finance & Loan Corp. (C. F. & L.) and executed a one

year promissory note to evidence the loan; prepaying interest thereon in 1955 in the amount of $40,218.75. (A. 160, 162) At the same time that petitioner's purchase was effected, C. F. & L. sold an equivalent amount of United States Treasury notes without the knowledge or consent of petitioner. (A. 161, 178) Confirmation slips were issued covering both transaction. (A. 161)

On September 15, 1956 petitioner sold the United States Treasury notes for $1,007,500. C. F. & L. which had previously charged petitioner with $975,000 for the loan made to him, made an entry in its books crediting petitioner with the purchase price of $1,007,500. The balance of $32,500 was paid over to petitioner in 1956. (A. 164-5)

The Tax Court held that there was no actual purchase of Government securities, that petitioner's loans were lacking in substance and that there was no payment made of "interest" on "indebtedness" and, therefore, denied petitioner's claimed interest deduction. (A. 181) No appeal was taken from this portion of the Tax Court's decision.

The net out of pocket expense to petitioner resulting from the transaction described above was $7,718.75, the difference between the $40,218.75 paid in 1955 which was designated as interest and the $32,500 received in 1956 which petitioner reported as capital gain (this gain was subsequently eliminated from petitioner's taxable income pursuant to stipulation of the parties). (A. 165, 145-6) Petitioner entered into a substantially identical transaction in 1956 which was closed out in 1957 on which he sustained an out of pocket expense of $7,772.93. (A. 170)

Petitioner contended that these out of pocket expenses were deductible in full or in the alternative, as capital losses. The Tax Court denied a deduction for these losses and its opinion was affirmed by the Court of Appeals.

In 1957 petitioner entered into a different transaction involving the purchase and short sale of United States Government securities. On May 6, 1957 petitioner purchased from Livingstone Securities Corporation $3,000,000 United States Treasury 1½% notes (hereinafter referred to as 1½% notes) due October 1, 1961. His purchase was confirmed by Livingstone Securities Corporation acting as agent for another for a price of $2,748,750 plus accrued interest to date of purchase of $4,549.18. (A. 172-3, 224)

On May 7, 1957 petitioner instructed Livingstone to sell short for his account $3,000,000 United States Treasury 2¾% bonds (hereinafter referred to as 2¾% bonds) due September 15, 1961. (A. 172) Livingstone placed this order with Salomon Brothers & Hutzler (Salomon) a dealer in Government securities, directing that delivery of such bonds be made to Childs & Company, also a dealer in Government securities. Salomon confirmed the purchase from petitioner as principal for a price of $2,910,000 plus $12,105.98 in accrued interest. (A. 172-3, 223)

At the same time and without the knowledge or authorization of petitioner, Livingstone Securities Corporation placed an order with Childs for purchase by it of $3,000,000 2¾% bonds with delivery to Salomon for petitioner's account and directed Salomon to receive these bonds from Childs and pay $2,911,875 plus accrued interest of $12,105.98. (A. 173, 225)

By letter agreement dated May 8, 1957 petitioner agreed to deposit with Livingstone the $3,000,000 of 1½% notes which he had purchased as security for the loan of the 2¾% bonds which petitioner had sold short to Salomon. (A. 174, 226-8) Petitioner further agreed to deposit with Livingstone the sum of $168,806.80 in cash which repre-

sented the excess of the proceeds from the short sale of the 2¾% bonds over the amount paid for the 1½% notes. This sum and the amounts received as coupon interest on the 1½% notes were to be used to reimburse Livingstone for coupon interest due Livingstone on the 2¾% bonds which Livingstone had agreed to loan to petitioner to cover his short sale. (A. 173-4) Livingstone acknowledged receipt of the 1½% notes and $168,806.80 in cash to be held as collateral security for the return of the borrowed 2¾% bonds. (A. 173-4, 227-8)

Petitioner agreed to pay Livingstone $33,750 as a premium for the loan of the 2¾% bonds. This amount was paid by petitioner to Livingstone in 1957 by the issuance of four checks each in the amount of $8,437.50. (A. 174-5) In January, 1959, and January, 1960, Livingstone advised petitioner that petitioner had been charged a coupon expense of $82,500 in each of the years 1958 and 1959 in connection with the borrowed 2¾% bonds. (A. 176-7)

On his 1957 income tax return petitioner deducted $33,750 as a premium for borrowing the 2¾% bonds and $29,144.02 as the expense of carrying his short position. This latter amount consisted of the interest coupon due on the 2¾% bonds on September 15, 1957, less the interest accrued to the date of the short sale. (A. 176) Petitioner also reported interest income of $17,950.82 which represented the interest on the October 1, 1957 coupon on the 1½% notes which petitioner had purchased less the interest accrued to the date of purchase. (A. 176) In each of the years 1958 and 1959 petitioner deducted $82,500 as the expense of carrying a short position. This amount represented the interest coupons due on the 2¾% bonds which petitioner had sold short. Petitioner also reported interest income of $45,000 in each of such years being the interest income on the 1½% notes which petitioner had

purchased. (A. 176-7) The other taxpaper entered into similar transactions in the same years for different amounts.

The Tax Court disallowed the deduction for the premium as well as the expenses of carrying a short position and the Court of Appeals affirmed this holding.

Petitioner offered testimony before the Tax Court that the confirmation slip issued by Livingstone Securities Corporation reflected a sale made by that company to petitioner on May 6, 1957 of $3,000,000 1½% notes at the price appearing on the confirmation slip. The witness, a Vice President of Livingstone Securities Corporation, further testified that this confirmation slip was prepared under his supervision in the usual course of business and that it was the usual and ordinary course of the business of Livingstone Securities Corporation to prepare and issue such a confirmation slip. (A. 134-7) The accounting between the parties was reflected in statements sent by Livingstone to petitioner summarizing the income and expenses in connection with the transaction (A. 240-2) There was testimony that these statements were prepared in the usual and ordinary course of business under the witness's supervision and that they correctly reflected the figures appearing on the books of Livingstone. (A. 136-7)

QUESTIONS PRESENTED.

1. Does the fact that the anticipated profit on a transaction depends primarily on obtaining an ordinary interest deduction to offset against capital gain income prevent the losses incurred therein from being deductible under section 165 (c) of the Internal Revenue Code of 1954 which grants a deduction for losses on transactions entered into for a profit?

2. If petitioner did not sustain an ordinary loss, did he sustain a loss attributable to his failure to exercise an option to buy property?

3. Where a taxpayer enters into a contract, may the acts of the other party to the contract be imputed to the taxpayer where such acts are not part of the contract either expressly or by implication; are not authorized by the taxpayer; and are performed without the taxpayer's knowledge?

REASONS FOR GRANTING THE WRIT OF CERTIORARI.

1. IN DETERMINING WHETHER A TRANSACTION WAS ENTERED INTO FOR A PROFIT, THE IMPACT OF FEDERAL INCOME TAXES IS A LEGITIMATE CONSIDERATION.

The Tax Court found that one of petitioner's motivations, albeit not the primary motivation, in entering into the earlier bond transactions was the expectation of realizing a profit if the bonds appreciated sufficiently to exceed petitioner's interest payment. Nevertheless, for the purpose of this petition for writ of certiorari, it is assumed that petitioner's sole motivation for entering into the transactions was to realize a cash increment after anticipated federal income tax consequences. There is no dispute on the record that in petitioner's tax bracket the $40,218 in interest which he paid in 1955 would have cost him approximately $16,000 in cash if the payment was tax deductible. The gain of $32,500 which petitioner reported in 1956 as long term capital gain on the sale of the bonds would have resulted in a tax of approximately $8,000 leaving $24,000 in cash. After deducting the $16,000 of net interest cost from the $24,000 remaining from the capital gain, petitioner would have realized an $8,000 cash profit on the transaction. A similar result would have ensued in the 1956-7 transaction.

In entering into the transactions petitioner acted in good faith and relied on the advice of competent tax counsel. He fully expected to obtain a large interest deduction and a capital gain so that he would realize a profit even if the bonds did not materially appreciate in

value. The profit did not materialize because the Court held that the transaction lacked economic substance and, therefore, disallowed petitioner's interest deduction and eliminated the capital gain from taxable income. As a result, instead of realizing a cash profit petitioner incurred a net cash out of pocket loss in 1956 of $7,718.75. Similarly, a loss of $7,772.93 was incurred in 1957.

Section 165 (c) 2 of the International Revenue Code of 1954 grants a deduction for a loss incurred in a transaction entered into for a profit even though not connected with the taxpayer's trade or business. The Court of Appeals read this Section as excluding anticipated tax benefits from the ambit of profits. It held that when petitioner failed to secure the interest deduction he sought, he could not "seek reward for expenses incurred in achieving this failure". The Court further held that there was no profit motive because the transaction lacked substance.

This interpretation of the statute ignores the realities of economic life and carries the sham transaction doctrine far beyond its logical or proper consequences. No businessman of any substance enters into a transaction without first carefully calculating and weighing the anticipated tax consequences. The term "profit" in its plain meaning to any taxpayer refers to the amount of economic benefit which he retains after paying all of his expenses including income taxes. Certainly the Court could not have meant that a taxpayer is to be penalized for taking federal income taxes into consideration in assessing whether to enter into a transaction. The grant of a deduction for a loss on such a transaction is not a reward to the taxpayer since the deduction minimizes but does not eliminate the loss. The basic purpose of the Code Section is to provide just such relief.

In holding similar transactions to be shams lacking in substance, the Court have not gone so far as to conclude that the transactions did not result in the creation of binding contractual benefits and obligations. For example, in *Knetsch* v. *Commissioners*, 364 U.S. 361 (1960), while this Court held the transaction to be a sham insofar as it failed to create a real indebtedness which could give rise to an interest deduction within the meaning of the taxing statute, the Court nevertheless did not hold that the taxpayer's annuity contract with the insurance company was not a valid contract or that the promissory note which he signed was not enforceable according to its terms. Similarly in this case, petitioner's contract with Livingstone was real in the sense that he acquired certain rights thereunder and undertook certain obligations. It was sham only insofar as it failed to create a bona fide indebtedness for tax purposes. It was real in that it necessarily would result in a profit or loss to petitioner.

The profit which taxpayer expected depended on the interplay between the income tax rates on ordinary income and the twenty-five per cent limitation on capital gains. Because of this tax structure it is possible for a taxpayer to pay out more dollars before taxes than he receives in return and still realize a cash increment after the tax consequences are taken into account. This cash increment is a profit in the truest sense of the word. Where a taxpayer enters into a transaction in which he expects to obtain such an increment, he is truly seeking a profit within the meaning of Section 165 (c) 2. By the express terms of this Section, the profit need not be connected with the taxpayer's trade or business. Where the taxpayer realizes a loss because the anticipated tax benefits do not materialize, the loss has certainly been incurred in a transaction originally entered into for a profit.

In reality, the Court of Appeals, and the Tax Court have equated the term "profits" as used in Section 165 (c) 2 with the concept of taxable income but there is no statutory justification for this position. The Federal Income Tax is levied on taxable income. This is defined in Section 63 (a) as gross income minus allowable deductions. There is no tax on "profits" as such. The lower Courts made no distinction between the two terms and yet it is clear that "income" is a term of art carefully defined by the Code whereas "profits" is used in its ordinary meaning as the excess of receipts over expenditures. It is a matter of fundamental importance to the administration of the Federal Income Tax that this distinction be clearly understood by the Courts whose duty it is to interpret the statute.

2. THE DECISION OF THE SEVENTH CIRCUIT IN REFUSING TO GRANT A CAPITAL LOSS FOR TAXPAYER'S OUT OF POCKET LOSSES IS IN DIRECT CONFLICT WITH DECISIONS OF THE SECOND AND NINTH CIRCUITS.

Petitioner argued in the alternative that his out of pocket expenses if not deductible as losses incurred in a transaction entered into for a profit, were deductible as a capital loss resulting from the failure to exercise an option to buy property under the provisions of Section 1234 of the Internal Revenue Code of 1954. Petitioner relied upon the decisions of the Second Circuit in *Lynch* v. *Commissioner*, 273 F.2d 867 (1959) and *Becker* v. *Commissioner*, 277 F.2d 146 (1960) and the Ninth Circuit in *MacRae* v. *Commissioner*, 294 F.2d 56 (1961). The facts in all of these cases were substantially identical to the facts in the case presented below. The Court of Appeals for the Seventh Circuit recognized this, but stated that it disagreed with those decisions and reached the opposite

result. The decision of the Seventh Circuit is also contrary to dicta contained in *Goodstein* v. *Commissioner*, 267 F.2d 127 (1st Cir. 1959). Petitioner respectfully submits that this direct conflict between the Circuits in substantially identical cases is one that should be resolved by a decision of this Court.

3. THE TAX CONSEQUENCES OF A TRANSACTION SHOULD BE DETERMINED BY THE ACTIONS OF THE TAXPAYER AND NOT THE ACTIONS OF OTHER PARTIES WHICH WERE NOT AUTHORIZED OR REQUIRED AND WHICH WERE NOT PERFORMED AS TAXPAYER'S AGENT.

If this case is heard on the merits petitioner is of the opinion that the record will show that in 1957 Livingstone at petitioner's direction and for petitioner's account sold short $3,000,000 worth of United States Government bonds 2¾% due September 15, 1961 and simultaneously therewith Livingstone Securities Corporation purchased $3,000,000 U.S. Treasury 1½% notes due October 15, 1961. The record is also clear that petitioner entered into certain binding agreements with Livingstone under which funds were deposited and mutual obligations undertaken.

According to both the Tax Court and the Court of Appeals the fatal defect in the transaction was that Livingstone, at the same time he effected the short sale for petitioner, bought and delivered $3,000,000 2¾% bonds due September 15, 1961, thus closing out petitioner's short position. As a result of this the Courts below concluded that the transaction was in effect a nullity having no independent economic or business purpose aside from anticipated tax benefits.

Neither the Tax Court nor the Court of Appeals accorded any significance to the stipulated fact that Living-

stone's action in buying in bonds to close out petitioner's short position was done without petitioner's knowledge or consent. The contract between the parties did not require either expressly or by implication that such action be taken by Livingstone. As a matter of law and fact, Livingstone was not acting as taxpayer's agent in effecting this purchase but was acting as an independent contractor.

The logical consequence of this decision is to put every investor on notice that his rights may be substantially affected by the independent actions of the broker with whom he deals. Moreover, the lower Court imposed an undue burden on the petitioner by holding that he was required to prove that Livingstone owned bonds which he could loan to petitioner or possessed funds in sufficient amounts to purchase such bonds and lend them to petitioner. We know of no other group of tax cases which hold that the taxpayer's burden of proof goes so far as to require them to show the financial responsibility of a licensed securities dealer with whom the taxpayer does business. A similarly onerous burden of proof was imposed upon petitioner in connection with the 1½% notes which were purchased for petitioner's account. The Courts below held that there was no evidence to show that these notes were ever actually purchased by petitioner. This ignores the record which contains a confirmation slip showing that the purchase and the evidence of the Vice President of Livingstone Securities Corporation who testified that this confirmation was prepared under his supervision in the usual and ordinary course of the corporation's business. Respondent offered no evidence to the contrary and did not even cross examine the witness on this point.

Judicial notice may be taken of the fact that millions of dollars worth of securities are purchased and sold each year without the investor ever seeing any documentary evidence thereof except the confirmation slip. It is an extension of the burden of proof heretofore imposed on taxpayers to require proof going beyond the confirmation slip as well as proof of the financial responsibility of the brokers with whom taxpayers transact their business. Concededly, the burden of proof in tax cases rests with the taxpayer but petitioners respectfully suggest that this burden of proof has been met in the instant case and that the requirements of the Courts below imposes an impossible burden of proof on taxpayers. These holdings establish a new requirement of evidentiary burden which deserves the consideration of this Court before being accepted as law.

Respectfully submitted,

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APPENDIX.

T. C. Memo. 1962-306

TAX COURT OF THE UNITED STATES

LOUIS H. LEWIS and ANNETTE LEWIS, et al.,[1] Petitioners,

v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 83732, 85749, 94018, Filed December 31, 1962.
83733, 85750, 94019.
85162, 91963,

William P. Rosenthal, Esq., for the petitioners.

Seymour I. Sherman, Esq., and Joseph T. deNicola, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

SCOTT, *Judge:* In these consolidated cases respondent determined deficiencies in income taxes of the petitioners for the taxable years and in the amounts as follows:

Docket Number	Petitioner	Taxable year	Deficiency
83732	Louis H. Lewis and Annette Lewis	1955	$24,316.08
		1956	28,202.87
83733	Estate of Hyman Furst, Deceased, Louis H. Lewis, Executor	1955	40,992.05
		1956	42,908.03

[1] Proceedings of the following petitioners are consolidated herewith: Louis H. Lewis and Annette Lewis, Docket Nos. 83732, 85749, and 94018; Estate of Hyman Furst, Deceased, Louis H. Lewis, Executor, Docket Nos. 83733, 85750, and 94019; and Samuel Pearl and Mary Pearl, Docket Nos. 85162 and 91963.

85162	Samuel Pearl and Mary Pearl	1955	25,806.08
		1956	26,976.62
		1957	38,048.98
85749	Louis H. Lewis and Annette Lewis	1957	55,511.54
85750	Estate of Hyman Furst, Deceased, Louis H. Lewis, Executor	1957	88,514.98
94018	Louis H. Lewis and Annette Lewis	1958	62,892.92
		1959	65,234.85
94019	Estate of Hyman Furst, Deceased, Louis H. Lewis, Executor	1958	96,952.86
		1959	99,411.66
91963	Samuel Pearl and Mary Pearl	1958	36,720.41
		1959	48,846.28

The issues presented for decision are:

(1) Whether petitioners are entitled to deductions as interest paid of amounts paid to Corporate Finance and Loan Corporation of Boston, Massachusetts, in 1955 and 1956.

(2) If the claimed interest deductions are not allowable, whether petitioners should be allowed for 1956 and 1957 deductions for losses incurred in transactions entered into for profit or as losses incurred because of alleged fraud or misrepresentation, or, in the alternative deductions for long-term capital losses in amounts which represent the difference between the amounts received and the amounts paid out by each petitioner in the transactions.

(3) Whether petitioners are entitled to deductions as premiums for borrowing bonds of amounts paid by them to M. Eli Livingstone in the taxable years 1957, 1958, and 1959.

FINDINGS OF FACTS

Some of the facts have been stipulated and are found accordingly.

Louis H. Lewis and Annette Lewis, husband and wife residing in Chicago, Illinois, filed a joint Federal income

tax return on the cash basis for each of the calendar years 1955, 1956, 1957, 1958, and 1959 with the district director of internal revenue at Chicago, Illinois. Samuel Pearl and Mary Pearl, husband and wife residing in Chicago, Illinois, filed a joint Federal income tax return on the cash basis for each of the calendar years 1955, 1956, 1957, 1958, and 1959 with the district director of internal revenue at Chicago, Illinois.

Louis H. Lewis is a duly appointed and authorized executor of the last will and testament of Hyman Furst, deceased. Hyman Furst filed his Federal income tax returns for the calendar years 1955, 1956, 1957, 1958, and 1959 on the cash basis with the district director of internal revenue at Chicago, Illinois.

Annette Lewis and Mary Pearl did not actively participate in any of the transactions here involved. Louis H. Lewis (hereinafter referred to as Lewis) and Hyman Furst (hereinafter referred to as Furst) were partners in a collection agency known as "Furst and Furst," with offices in Chicago, Illinois. Samuel Pearl (hereinafter referred to as Pearl) is an attorney with offices in Chicago, Illinois. Lewis had known Pearl for approximately 8 years in 1955.

Lewis, Furst, and Pearl reported adjusted gross income for Federal income tax purposes for the years and in the amounts as follows:

Year	Lewis	Furst	Pearl
1955	$ 78,270.13	$ 80,568.00	$ 97,745.60
1956	106,140.34	114,765.14	87,886.17
1957	117,217.42	120,597.76	114,247.30
1958	82,708.95	72,185.19	91,255.49
1959	101,338.92	90,881.61	107,132.97

In 1955 Lewis visited Maxwell Abbell (hereinafter referred to as Abbell) for the purpose of having Abbell draw his will. Abbell discussed with Lewis the amount of his income and the portion thereof which he paid in tax

and suggested that he could assist Lewis in making investments, including purchases of timber, Government securities, and certain stock, the income from which would be more favorably treated from a tax point of view. Abbell stated that he would have a gentleman call upon Lewis and shortly thereafter, Gerald G. Bolotin (hereinafter referred to as Bolotin) came to Lewis' office and Lewis learned that he had been referred to Bolotin by Abbell. Bolotin told Lewis of opportunities to buy securities which would be explained to Lewis in greater detail at subsequent meetings.

Bolotin was a Chicago attorney who acted for M. Eli Livingstone in seeking to interest persons in Livingstone's plans. At all times material M. Eli Livingstone was a security dealer in Boston, Massachusetts, doing business in the form of a sole proprietorship under the name of Livingstone and Company. Both M. Eli Livingstone and Livingstone and Company will be referred to hereinafter as "Livingstone." Livingstone developed and promoted a number of plans attractive to taxpayers with large incomes, an essential feature of which was the deduction for income tax purposes of amounts characterized as consideration for the borrowing of funds or securities. Bolotin received a fee or commission for each contact produced by him for Livingstone which resulted in a transaction. Lewis, Furst, and Pearl first became aware of the activities of Livingstone through Bolotin.

After his first meeting with Bolotin Lewis held other meetings with Bolotin and with Livingstone, or with both Bolotin and Livingstone. At one of these meetings Livingstone suggested to Lewis that Lewis purchase large amounts of Government securities. This same plan was suggested by Livingstone to Pearl and Furst. Lewis asked Livingstone to outline his plan in writing so that he could study the proposal in detail.

A proposal in writing was subsequently submitted to Lewis by Livingstone. While Lewis was debating the advisability of proceeding with the plan, he received a copy

of a legal opinion addressed to Bolotin from a Chicago law firm.

After reading the proposal, Lewis contacted Arthur Wasserman, an attorney in Boston, Massachusetts, who was a friend of Lewis and asked for information about Livingstone. Wasserman stated that he knew Livingstone and told Lewis that Livingstone had been in the securities and investment business for some time, that he had been successful in that business, that he had a home that was worth about $250,000, and was quite wealthy.

Lewis then discussed Livingstone's proposal and the legal opinion addressed to Bolotin with a certified public accountant in Chicago. Lewis regarded this accountant as a tax expert. The accountant examined the proposal and cautioned Lewis that if he entered the transaction, he should be certain to receive the serial numbers of the bonds, and should refuse to enter the transaction without such assurance.

By letter dated November 18, 1955, Livingstone informed Lewis that he felt very strongly that the turning point in the bond market was at hand. He stated further that, historically, there is a premium for the "rollover" privilege on bonds which are held by an investor. Livingstone explained that "rollover" means the right to exchange the expiring or maturing issue for a new one which replaces it. Livingstone urged Lewis to buy United States Treasury 2⅞ percent notes because of the favorable condition and the generous yield that they offered. He stated also that the future prospect is a very substantial capital appreciation owing to the rollover privilege.

Upon the basis of the information and advice he had received, Lewis decided to enter into the transactions proposed by Livingstone. His reasons for making this decision were that his income tax bracket enabled him to make good use of a deduction for interest which would not otherwise be available, the bonds purchased might acquire additional value if the Government would permit them to be exchanged on maturity for bonds of a higher interest rate,

he was given an option to sell the bonds which limited his losses if the bonds declined in value, and there was the possibility of a rise in value of the bonds which might result in an economic gain to him. Lewis also considered the fact that any gain on the sale of the bonds would be taxable as a capital gain. Louis would not have entered into the transaction under the plan submitted to him by Livingstone except for the anticipated tax benefit to be derived therefrom.

Petitioners Furst and Pearl relied upon Lewis' investigation of Livingstone's proposals. They felt that Lewis was methodical and would explore a business proposal carefully. They also decided on November 25, 1955, to enter into the transactions proposed by Livingstone. Their decision was based largely upon Lewis' conclusion as to the advisability of entering into the transactions and their primary purpose in entering the transactions was also to reduce their Federal income taxes. Pearl also relied on the legal opinion of the Chicago law firm issued to Bolotin.

On or about November 22, 1955, Lewis directed Livingstone to purchase for his account $1,000,000 face value United States Treasury 2⅞ percent notes due March 15, 1957, with interest coupons due March 15, 1956, and September 15, 1956, detached.

A letter dated November 22, 1955, sent to Lewis by Livingstone stated, in part, as follows:

> We have this day sold to you:
>
> $1,000,000 U.S. Treasury 2⅞% Notes due March 15, 1957, with 3/15/56 and 9/15/56 coupons detached
>
> For $1.00 and other valuable consideration, receipt of which is hereby acknowledged, we hereby grant you an irrevocable option to sell these notes to us on September 15, 1956, at a price of 100¾.
>
> It is intended that the above identified notes shall be used in exercising this option, and the option, if exercised, shall be exercised through the sale by you or your assigns to us of the above identified notes.

Livingstone made no charge for the option to sell or "put" the Treasury notes.

Enclosed in a letter from Livingstone to Lewis dated November 22, 1955, were a confirmation slip showing a purchase by Lewis of $1,000,000 United States Treasury 2⅞ per cent notes due March 15, 1957, with interest coupons due March 15, 1956, and September 15, 1956, detached at a price of 97½ or a total price in the amount of $975,000, a note for Lewis' signature, letters of instruction for Lewis' signature, and the letter dated November 22, 1955, a part of which has been quoted heretofore. Also enclosed were copies of the papers for Lewis' signature for his file and Livingstone's check in the amount of $32,500 as an advance. This amount was paid to Lewis as security for the option granted to him to sell the notes to Livingstone at a price in excess of par at maturity. Lewis did not sign a note for this amount and it was not accounted for until the close of the transaction in 1956 when it was charged to Lewis' account. Livingstone's check for $32,500 was deposited in Lewis' regular account and was not set aside in a special fund or placed in escrow. No commission was charged by Livingstone for the transaction stated to be a sale to Lewis of the $1,000,000 United States Treasury 2⅞ percent notes. The lack of a charge for commission is customary where a broker sells Government notes as principal, and for his own account. The confirmation slip indicated that this transaction was one in which Livingstone acted as principal in the sale of the bonds.

Lewis was requested to sign the note and letter of instruction and return them to Livingstone's office, together with this check in the amount of $40,218.75 made payable to Corporate Finance and Loan Corp. (hereinafter referred to as CF&L), which amount was stated to represent Lewis' prepayment of interest.

By means of the prepared letters furnished him by Livingstone, Lewis directed Livingstone to deliver the notes against payment of $975,000 to CF&L and directed CF&L to pay this amount and receive the notes from Livingstone.

Lewis executed an instrument dated November 22, 1955, in the form of a one-year promissory note in favor of CF&L in the amount of $975,000, with interest at 4⅛ percent per annum through November 22, 1956, in the amount of $40,218.75 having been prepaid by Lewis. The note recited that Lewis had deposited with CF&L as collateral $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957, with March 15, 1956, and September 15, 1956, coupons detached. The note contained no provision for the reimbursement of interest in any amount to Lewis by CF&L if the principal amount were paid previous to the due date recited therein. This note contained a provision that it should be construed and interpreted in accordance with the laws of the State of Illinois, and also contained the following provisions:

> The undersigned gives to the obligee a lien against the securities pledged for the amount of the obligation set forth herein and gives to the obligee the right to hypothecate and use the securities pledged for any purpose while so pledged. Said right is not to be inconsistent in any manner with the ownership by the undersigned of the said collateral, and with the right of the undersigned to obtain the return of the collateral at any time upon tender of payment of the amount due hereunder.

The transactions were recorded on the books of CF&L by entries showing a debit to the account entitled "Notes Receivable, Clients" and a credit entry to the account entitled "Loans Receivable Livingston & Co." in the amount of $975,000.

Livingstone placed an order with Salomon Brothers and Hutzler (hereinafter called Salomon), dealers in Government securities, designated as and for the account of Lewis, directing the delivery of $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957, to the Chemical Corn Exchange Bank of New York (hereinafter referred to as Chemical Bank) against payment.

The Chemical Bank was instructed by Livingstone to receive the foregoing notes from Salomon against payment.

Livingstone placed an order with Salomon directing the sale for the account of CF&L, and the receipt of $1,000,000 United States Treasury 2⅞ percent notes, due March 15, 1957, from Chemical Bank against payment. Livingstone instructed Chemical Bank to deliver the foregoing notes to Salomon covering both transactions, and Salomon issued confirmation slips to Livingstone covering both transactions. Livingstone paid Salomon the differential between the purchase and the sale prices.

Chemical Bank credited and debited Livingstone's account in the amounts of the sale price and purchase price, respectively, of the foregoing securities, and issued a credit advice and a debit advice accordingly. It ultimately received a clearing fee for its services.

The notes in question never left the office of Salomon, and neither Lewis, Livingstone, nor CF&L ever acquired actual physical possession thereof. It is common practice among security dealers to "pair off" orders to buy and orders to sell the same security, and to dispense with physical delivery except as to any net excess of purchases or sales.

The confirmation slip sent to Salomon in response to Livingstone's order to deliver mentioned Lewis by name only because of Livingstone's request. This was not normally done in the usual course of Salomon's business.

Lewis issued a check dated December 1, 1955 in favor of CF&L in the amount of $40,218.75.

A document designated as an interest statement of CF&L dated November 22, 1955, was sent to Lewis with the following notation thereon: "Interest on loan of $975,000.00 (a) 4⅛% for one year from 11/22/55 through 11/22/56—— $40,218.75."

By letter dated December 7, 1955, CF&L advised Lewis that it had received from Livingstone for Lewis $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957, with March 15, 1956, and September 15, 1956, coupons

detached, bearing certain bond sic numbers [presumably note numbers], which it purported to set forth therein.

CF&L is a corporation which was organized in 1954 under Massachusetts law with $1,000 of contributed capital. Thereafter, no further capital contributions were made.

Harry W. Cushing, a friend and former law associate of Livingstone, was at all times material hereto, an attorney in Boston, Massachusetts. Cushing's law office and the office of CF&L were located at all times here material, in the same premises at 70 State Street in Boston. During the period here in issue, Cushing was the president and treasurer and one of the shareholders of CF&L. All other shareholders were friends, relatives or clients of Cushing. Cushing and one of his children, who served as clerk at the directors' meetings, held three or four times each year, were the corporation's only employees. For the fiscal year ending March 11, 1956, they received salaries of $15,882 and $3,975, respectively, from the corporation.

The tangible asse s of CF&L consisted of client folders, books and records, a supply of letterhead stationery and promissory notes executed in its favor by clients.

The correspondence of CF&L was typed and prepared on its letterhead stationery by Livingstone's office, for which service CF&L paid Livingstone. Cushing's principal activities as the president and treasurer of CF&L were to receive and deposit payments from clients and pay out corporate funds.

Substantially all the business of CF&L was received on reference from Livingstone. CF&L never sought or received a credit report on any person with whom it did business.

CF&L maintained its books and records on the basis of a fiscal year ending March 31. For its fiscal years 1955 and 1956 it filed "Certificates of Condition" with the Secretary of State of the Commonwealth of Massachusetts, showing the following assets and liabilities:

	Fiscal Year Ended March 31, 1955	Fiscal Year Ended March 31, 1956
Assets		
Cash	$ 7,504.07	$ 2,783.06
Accounts Receivable Customers	65,950,323.55	280,430,957.38
Prepaid Insurance, Interest, Taxes	45.99	37.47
Total Assets	$ 65,957,873.61	$280,433,777.91
Liabilities		
Accounts Payable	$ 57,249,044.32	$270,812,038.97
Accrued Bond Expense	472,085.94	4,001,327.50
Deferred Interest	2,922,092.95	6,613,528.32
Bonds Borrowed	6,240,000.00	———
Payroll Taxes Withheld	———	195.00
Capital Stock, without part	1,000.00	1,000.00
Surplus	(926,349.60)	(994,311.88)
Total Liabilities	$ 65,957,873.61	$280,433,777.91

At the end of each fiscal year, Livingstone and Cushing decided the amounts to be paid to Livingstone by CF&L for the transactions which had taken place.

Livingstone sent a letter to Lewis dated September 5, 1956 enclosing the necessary documents to close out Lewis' transaction involving the $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957. Livingstone requested Lewis to sign the enclosed instruction letters as indicated to release the notes from Lewis' account and return the papers to Livingstone's office. Livingstone stated further that on September 15, 1956, he would confirm purchase of these securities from Lewis, discharge his loan, and have his "paid and cancelled" note returned to him. Also enclosed was a statement prepared as of September

15, 1956 reflecting the status of Lewis' account. The latter indicated at the bottom of the page that a carbon copy was being sent to Maxwell Abbell.

A confirmation slip dated September 15, 1956, was sent by Livingstone to Lewis, stating that Livingstone, as principal and for their own account, bought of Lewis $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957 at 100¾. The confirmation slip does not show any commission charged.

Pursuant to Livingstone's instruction, by letter dated September 15, 1956, Lewis directed CF&L to deliver from his account to Livingstone $1,000,000 United States Treasury 2⅞ percent notes due March 15, 1957 against a payment by Livingstone of $975,000. He also directed CF&L to use the proceeds to discharge his outstanding loan.

Livingstone issued a ledger statement or statement of account to Lewis dated September 15, 1956, indicating the following:

Date	Sold or Delivered	Description	Price	Debit	Credit	Balance
9/15/56	1000M	U.S. Treasury 2⅞ percent Notes due March 15, 1957	100¾		$1,007,500.00	
		Paid to the Corporate Finance Loan Corp. for your account		$957,000.00		
		Paid to you		32,500.00		
		Balance				$0.00

Thereupon CF&L made entries in its books indicative of payment of the amount of $975,000 shown thereon as due to it from Lewis and sent to Lewis, marked as paid, the instrument dated November 22, 1955, in the form of the 1 year promissory note to CF&L signed by Lewis.

The net out-of-pocket expense to Lewis resulting from the foregoing transactions of November 22, 1955 and

September 15, 1956, was in the amount of $7,718.75, the difference between the amount paid out designated as interest of $40,218.75 and the amount received from Livingstone as security for the put in the amount of $32,500 and subsequently credited to Lewis' account.

Furst and Pearl entered into transactions at about the same time as Lewis identical in all material respects with those described herein with respect to Lewis, except that in the case of Furst, the face amount of the securities involved was $1,400,000; the amount designated as the purchase price and as the loan from CF&L was $1,365,000; the amount designated as interest paid to CF&L was $56,306.25; the advance by Livingstone was $45,500 and the net-out-of-pocket expense was in the amount of $10,806.25.

On or about March 22, 1956, Lewis, Furst and Pearl each entered into another transaction planned by Livingstone.

On or about March 22, 1956, Lewis directed Livingstone to purchase for his account $1,000,000 face-value United States Treasury 2⅞ percent notes due June 15, 1958, with interest coupons due June 15, 1956 and December 15, 1956 detached.

Under date of March 22, 1956, Livingstone delivered a letter to Lewis which stated, in part, as follows:

> We have this day sold to you:
>
> $1,000,000 U.S. Treasury 2⅞% Notes due June 15, 1958 with 6/15/56 and 12/15/56 coupons detached For $1.00 and other valuable consideration, receipt of which is hereby acknowledged, we hereby grant you an irrevocable option to sell these notes to us at any time from December 15, 1956, through June 15, 1957, at a price of 101.
>
> It is intended that the above identified notes shall be used in exercising this option, and the option, if exercised, shall be exercised through the sale by you or your assigns to us of the above identified notes.

Livingstone made no charge for the option to sell or "put" the above-mentioned Treasury notes.

On or about March 22, 1956, Livingstone advanced Lewis the amount of $36,250 by check as security for the option granted to Lewis to sell the notes to Livingstone at a price in excess of par at maturity.

Livingstone sent Lewis a confirmation slip dated March 22, 1956, stating that as principal and for their own account they had sold to Lewis $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958, with June 15, 1956 and December 15, 1956 coupons detached at a price of 97⅜, or a total price in the amount of $973,750. No commission was charged for this transaction.

Lewis directed Livingstone to deliver the notes against payment of $973,750 to CF&L and directed CF&L to pay this amount and to receive these notes from Livingstone.

Lewis executed an instrument dated March 22, 1956 in the form of a promissory note due August 20, 1957, in favor of CF&L in the amount of $973,750 "with interest at the rate of 4¼% per annum, through August 20, 1957, in the amount of $58,397.93, of which $44,022.93" was recited as having been paid, and the coupons maturing on June 15, 1957, having a value of $14,375 were assigned to CF&L. The instrument stated further that the obligation of Lewis to prepay interest was limited to $44,022.93, that Lewis would not be obligated to make any payment of the assigned interest coupons, and that Lewis deposited as collateral with CF&L $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958, with June 15, 1956 and December 15, 1956 coupons detached. The note contained no provision for the reimbursement of interest in any amount to Lewis by CF&L if the principal amount were paid previous to the due date recited therein. It contained a provision that it should "be construed and interpreted in accordance with the laws of the State of Illinois," and also contained the following provisions:

> The undersigned gives to the obligee a lien against the securities pledged for the amount of the obliga-

tion set forth herein and gives to the obligee the right to hypothecate and use the securities pledged for any purpose while so pledged. Said right is not to be inconsistent in any manner with the ownership by the undersigned of the said collateral and with the right to the undersigned to obtain the return of the collateral at any time upon tender of payment of the amount due hereunder.

The undersigned shall not be called upon to furnish additional collateral during the term of this Note.

CF&L made a debit entry on its books in the amount of $973,750 to the account entitled "Notes Receivable, Clients" and a credit entry in the same amount to the account entitled "Loan Receivable, Livingstone & Company."

Livingstone placed an order with Salomon designated as for the account of Lewis directing the delivery of $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958 to the Chemical Bank against payment.

Livingstone instructed the Chemical Bank to receive the foregoing notes from Salomon against payment.

Livingstone placed an order with Salomon directing the sale for the account of CF&L and the receipt of $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958 from the Chemical Bank against payment. Livingstone instructed the Chemical Bank to deliver the foregoing notes to Salomon against payment. Livingstone issued confirmation slips to Salomon covering both transactions, and Salomon issued confirmation slips to Livingstone covering both transactions. Livingstone paid Salomon the differential between the purchase and the sales price.

The Chemical Bank credited and debited Livingstone's account in the amounts of the sale price and purchase price, respectively, of these securities, and issued a credit advice and a debit advice accordingly. It ultimately received a clearing fee for its services.

The notes never left the office of Salomon, and neither Lewis, Livingstone, nor CF&L ever acquired actual physical possession thereof. It is common practice among security dealers to "pair off" orders to buy and orders to sell the same security, and to dispense with physical delivery, except as to any net excess of purchases or sales.

The confirmation slips sent to Salomon in response to Livingstone's order to delivery mentioned Lewis by name only because of Livingstone's request. This was not normally done in the usual course of Salomon's business.

On May 15, 1956, Lewis issued a check to CF&L in the amount of $44,022.93.

CF&L in a letter to Lewis dated June 14, 1956 set forth the serial numbers of the $1,000,000 United States Treasury 2⅞ percent notes of June 15, 1958, with June 15, 1956 and December 15, 1956, coupons detached which were stated in this letter to have been received by CF&L from Livingstone for Lewis' account.

On March 4, 1957, Lewis advised Livingstone that he wished to exercise the option granted to him on March 22, 1956, on the following day.

A confirmation slip dated March 5, 1957 was sent to Lewis by Livingstone stating that Livingstone as principal and for their own account bought $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958, at 101, plus $6,318.68 interest, making a total of $1,016,318.68. The confirmation slip does not show any commission charged.

By letter dated March 5, 1957, Lewis directed CF&L to deliver from this account to Livingstone $1,000,000 United States Treasury 2⅞ percent notes due June 15, 1958, against payment from Livingstone of $980,068.68. Lewis further requested that these proceeds be used to discharge his obligation to CF&L in the amount of $973,750 plus interest due of $6,318.78. By letter of the

same date Lewis directed Livingstone to receive from his account at CF&L these Treasury notes against payment to them of $980,068.68.

A ledger statement or statement of account from Livingstone to Lewis dated March 5, 1957, reflects the following:

Date	Sold or delivered	Description	Price	Debit	Credit	Balance
March 5, 1957	$1,000,000	U. S. Treasury 2-7/8 percent notes due June 15, 1958	101		$1,016,318.68	
		Cash		$980,068.68		
		Balance (check enclosed)				$36,250.00

CF&L sent Lewis a statement of the account of Lewis with CF&L dated March 5, 1957, which showed the following:

Note dated March 22, 1956	$973,750.00
Interest due to cover period December 15, 1956 through March 5, 1957	6,318.68
Total	$980,068.68

Received Payment
March 5, 1957

/s/ Harry N. Cushing

CF&L made entries in its books showing a payment in the amount of $973,750 to it by Lewis and sent to Lewis marked as paid, the instrument dated March 22, 1956, in the form of a promissory note to CF&L signed by Lewis.

The net out-of-pocket expense to Lewis resulting from these transactions was in the amount of $7,772.93, which amount represents the difference between the amount paid by Lewis to CF&L less the amount of $36,250 received by Lewis from Livingstone.

Furst and Pearl entered into transactions at or about the same time as Lewis identical in all material respects

with those which Lewis entered into, except that in the case of Furst, the face amount of the securities involved was $1,250,000; the amount designated as the purchase price and as the loan from CF&L was $1,217,187.50; the amount designated as interest paid to CF&L was $55,028.66; the advance by Livingstone was in the amount of $45,312.50; and the net out-of-pocket expense was in the amount of $9,716.16.

Livingstone sent Lewis a letter dated January 4, 1957, outlining a proposal for the short sale of United States Treasury bonds and the purchase of United States Treasury notes and enclosing a memorandum indicating the tax consequences of the plan to an individual filing a joint income tax return whose top income tax bracket was 90 percent. The memorandum indicated a net after tax profit in the amount of $35,094.53 to such an individual on a combination short sale of $1,000,000 United States Treasury 2¾ percent bonds and a purchase of $1,000,000 United States Treasury 1½ percent notes.

In a letter to Lewis dated May 6, 1957, Livingstone agreed to defend, at his own expense, any litigation which might arise in connection with any challenge by the Treasury Department with regard to any phase of the transaction involving the combination short sale of the United States Treasury bonds and the purchase of United States Treasury notes. In a second letter to Lewis dated May 6, 1957, Livingstone stated that he was clarifying and amplifying the transaction for the sale by Lewis of United States Treasury 2¾ percent bonds and purchase of United States Treasury notes. This letter further stated:

> 1. It is our understanding that the 1½% Notes are owned by you, and that in the event that you return to us the 2¾% Bonds at any time, we are obligated to return to you or your order the 1½% Notes and any cash collateral remaining to your credit.
>
> 2. It is our further understanding that we have agreed to accept the 1½% Notes and the cash de-

posited by you, as sufficient collateral, with the full realization that this cash deposit will be utilized for the payment of future coupon expense, and with the understanding that we are not to have the right to call for additional collateral at any time.

On or about May 7, 1957, Lewis instructed Livingstone to sell short for his account $3,000,000 United States Treasury 2¾ percent bonds due September 15, 1961, and to sell to him $3,000,000 United States Treasury 1½ percent notes due October 1, 1961.

By letter dated May 6, 1957, Lewis directed Livingstone Securities Corporation to deliver to Salomon for his account $3,000,000 United States Treasury 2¾ percent bonds due September 15, 1961, against payment from Salomon of $2,922,105.98. By letter of the same date Lewis directed Salomon to receive from Livingstone Securities Corporation these securities against payment.

Livingstone placed an order with Salomon, designated as for the account of Lewis, for the sale to Salomon of $3,000,000 United States Treasury 2¾ percent bonds due September 15, 1961.

A confirmation slip dated May 7, 1957, from Salomon to Lewis indicated that Salomon, as principal, purchased from Lewis $3,000,000 United States Treasury 2¾ percent bonds at 97. The principal amount came to $2,910,000 and the accrued interest was $12,105.98, making a total of $2,922,105.98. At the bottom of the slip the following appeared:

Del'y Terms
5/8/57 IN-NY (a) CHILDS

A confirmation slip showing a contract date of May 6, 1957, from Livingstone to Lewis indicated that Livingstone, acting as agent for another, sold to Lewis $3,000,000 United States Treasury 1½ percent notes of October 1, 1961, at 91⅝. The principal amount was $2,748,750 and interest $4,549.18, making a total of $2,753,299.18. No commission was charged.

Simultaneously, Livingstone Securities Corporation, an entity controlled by Livingstone, placed an order with C. S. Childs & Co. (hereinafter called Childs), dealers in Government securities, for the purchase by it from Childs of $3,000,000 United States Treasury 2¾ percent bonds due September 15, 1961, and their delivery against payment to Salomon for the account of Lewis. Livingstone instructed Salomon in a letter dated May 7, 1957, to receive from Childs the $3,000,000 United States Treasury 2¾ percent bonds against payment to Childs of $2,922,105.98.

By a letter to Livingstone dated May 8, 1957, Lewis acknowledged receipt of the same United States Treasury 2¾ percent bonds which had been purchased from Childs and simultaneously sold to Salomon. Lewis agreed that in return for the "loan" of these securities he would deposit with Livingstone United States Treasury 1½ percent notes in the face amount of $3,000,000.

Lewis further agreed that he would deposit with Livingstone cash in the amount of $168,806.80 to be applied together with coupons earned on the United States Treasury 1½ percent notes to reimburse Livingstone for coupons due Livingstone on the securities "borrowed" by Lewis. The amount of $168,806.80 represents the excess of the amount realized on the sale of the 2¾ percent notes and on the amount paid for the 1½ percent notes. Any balance remaining in Lewis' favor on September 15, 1961, was to be accounted for by Livingstone. Lewis further agreed to pay Livingstone for the "loan" of the United States Treasury 2¾ bonds a premium in the amount of $33,750 of which $8,437.50 was stated to be paid in advance, and a balance of $25,312.50 was to be paid in equal installments on or before August 1, 1957, October 1, 1957, and December 1, 1957.

By letter dated May 8, 1957, Livingstone acknowledged receipt from Lewis of $3,000,000 United States Treasury notes of October 1, 1961, and $168,806.80 in cash. The letter further stated:

The cash deposit in the amount of $168,806.80 together with coupons earned by you on the securities, is to be deposited with us as security to reimburse us for coupons on the securities loaned to you.

We agree that neither we nor any of our agents will call for the return of the securities loaned to you until September 15, 1961, and that neither we nor any of our agents will call upon you for any additional collateral during the term of this contract, and that you shall not be liable for the return of these securities unless the securities deposited by you shall be returned simultaneously.

In consideration, we are to receive the sum of $33,750.00 as premium for the loan of securities to cover your short position, of which $8,437.50 is payable in advance, and the balance of $25,312.50 is to be paid as follows:

$8,437.50 on or before August 1, 1957
$8,437.50 on or before October 1, 1957
$8,437.50 on or before December 1, 1957

The ledger sheet of Lewis' account with Salomon as of May 9, 1957, reflects the following:

Date	Bought or received	Sold or delivered	Description	Price	Debit	Credit	Balance
May 8, 1957		$3,000,000	U. S. Treasury 2¾ percent notes due Sept. 15, 1961	97		$2,922,105.98	
							$2,922,105.98
May 9, 1957	$3,000,000		U. S. Treasury 2¾ percent notes due Sept. 15, 1961	RCD	$2,922,105.98		.00

By letter dated May 21, 1957, Livingstone Securities Corporation informed Lewis that, in connection with their confirmation to Lewis of the $3,000,000 United States Treasury 1½ percent notes of October 1, 1961, and their delivery for Lewis' account of $3,000,000 United States Treasury 2¾ percent bonds of September 15, 1961, Livingstone Securities Corporation had acted solely as the agent

of Livingstone and that Lewis had no responsibility to Livingstone Securities Corporation whatsoever. The letter stated further that the corporation had not loaned Lewis any securities nor was it holding any securities belonging to Lewis; that his contract was with Livingstone and Company and that his sole responsibility was to that separate corporation.

In letters dated in June and July 1957, from Livingstone to Lewis numbers for 2¾ percent bonds and 1½ percent bonds stated to have been loaned to Lewis and held for Lewis were listed.

During 1957 Lewis issued four checks to Livingstone, each in the amount of $8,437.50.

By letter dated January 15, 1958, Livingstone issued the following statement of account to Lewis:

> For your 1957 income Tax purposes, we submit the following:
>
> On the $3,000,000 U. S. Treasury 2¾% Bonds of 9/15/61, borrowed from us on May 8, 1957, we debited your account with the following expense:
>
> | | | |
> |---|---|---|
> | 9/15/57 Coupons | $41,250.00 | |
> | Less Accrued Interest | 12,105.98 | |
> | Net Expense | | $29.144.02 |
>
> On the $3,000,000 U. S. Treasury 1½% Notes of October 1, 1961, being as collateral by us, you had the following income:
>
> | | | |
> |---|---|---|
> | 10/1/57 Coupons | $22,500.00 | |
> | Less Accrued Interest | 4,549.18 | |
> | Net Income | | $17,950.82 |
>
> A premium of $33,750.00 was paid for borrowing the 2¾% Bonds as follows:
>
> $8,437.50 on June 18, 1957
> $8,437.50 on August 1, 1957
> $8,437.50 on September 30, 1957
> $8,437.50 on December 3, 1957
>
> which is deductible from your Federal Income Tax.

By a letter dated January 15, 1959, Livingstone issued the following statement of account to Lewis:

For your 1958 Income Tax purposes, we submit the following

On the $3,000,000 U. S. Treasury 2¾% Bonds of September 15, 1961, borrowed from us on May 8, 1957, we debited your account with the following expense:

3/15/58	Coupons	$41,250.00
9/15/58	"	41,250.00
Total Expense		$82,500.00

On the $3,000,000 U. S. Treasury 1½% Notes of October 1, 1961, being held by us as collateral, you had the following income:

4/1/58	Coupons	$22,500.00
10/1/58	"	22,500.00
Total Income		$45,000.00

Your net deduction on this transaction is $37,500.00

By a letter dated January 14, 1960, Livingstone issued the following statement of account to Lewis:

For your 1959 Income Tax purposes, we submit the following:

On the $3,000,000 U. S. Treasury 2¾% Bonds of September 15, 1961, borrowed from us on May 8, 1957, we debited your account with the following expense:

3/15/59	Coupons	$41,250.00
9/15/59	"	41,250.00
Total expense		$82,500.00

On the $3,000,000 U. S. Treasury 1½% Notes of October 1, 1961, being held by us as collateral, you had the following income:

4/1/59	Coupons	$22,500.00
10/1/59	"	22,500.00
Total Income		$45,000.00

Your net deduction on this transaction is $37,500.00

Furst and Pearl entered into transactions at or about the same time as Lewis involving 2¾% percent bonds and 1½ percent notes identical in all material respects with those described with respect to Lewis, except that in the case of Furst the face amount of the bond stated to have been sold short and borrowed and the notes stated to have been purchased was $4,000,000; the amounts designated as the selling price of the bonds and purchase price of the notes were $3,986,141.30 and $3,655,000, respectively; the amounts designated as payments to Livingstone in 1957, 1958, and 1959 were $83,858.70, $110,000, and $110,000, respectively; and the amounts reported as interest income on the United States Treasury notes in 1957, 1958, and 1959 were $23,934.43, and $60,000, and $60,000, respectively.

Lewis and Pearl entered into the 1957 transactions for the purpose of effecting a tax savings, and with the hope of obtaining an economic gain if the 2¾ percent bonds depreciated sufficiently in value. They believed that the transactions initiated in May 1957 would be carried out as set forth in Livingstone's letter of January 4, 1957.

Lewis and Pearl were unaware of the financial condition of CF&L and of the fact that the securities involved in the transactions of November 1955 and March 1956 were simultaneously purchased for their accounts and sold for the account of CF&L.

On and after May 7, 1957, Lewis and Pearl followed the prices of United States Treasury 2¾ percent bonds in the daily market reports.

In his income tax return for the year 1955 Lewis deducted $40,218.75 as interest paid to CF&L and in his income tax return for the year 1956 deducted $44,022.93 as interest paid to CF&L.

In his income tax return for 1957, Lewis deducted the amount of $29,144.02 as "Cost of Borrowing U.S. Treasury Bonds" and the amount of $33,750 as "Premium paid for borrowing U.S. Treasury Bonds." In his 1958 income tax return Lewis deducted $82,500 as "Cost of borrowing U.S. Treasury Bonds" and in his 1959 income tax return deducted $82,500 as "Cost of borrowing U.S. Treasury Bonds."

In his notices of deficiency respondent disallowed the claimed interest deductions for 1955 and 1956 and the claimed deductions for 1957, 1958, and 1959 for premiums paid for and costs of borrowing United States Treasury bonds with the explanation that the amounts so claimed are not deductible under any section of the Internal Revenue Code of 1954.

In his income tax return for 1955, Furst deducted $56,306.25 as interest paid to CF&L and in his income tax return for 1956, he deducted $55,028.66 as interest paid to CF&L. In his income tax return for 1957 Furst deducted $45,000 as "Premium paid for loan of securities to cover short position," and $55,000 as "Coupon expense on $4,000,000 U.S.T. 2¾% Notes due 9/15/61."

In his income tax return for 1958 Furst deducted $110,000 as "coupon expense—cost of short position," and in his income tax return for 1959 deducted $110,000 with the same explanation.

Respondent in his notices of deficiency disallowed the claimed interest deductions for 1955 and 1956 and the claimed deductions for coupon expense and cost of borrowing bonds for 1957, 1958, and 1959 with the explanation that these amounts were not deductible under any provision of the Internal Revenue Code of 1954.

In his income tax return for 1955 Pearl deducted $40,218.75 as interest paid to CF&L and in his income tax

return for 1956 deducted $44,022.93 as interest paid to CF&L. In his income tax return for 1957, Pearl deducted $29,144.02 and $33,750 as "the cost of borrowing U.S. Treasury Bonds" and "Premium paid for borrowing U.S. Treasury Bonds." In his income tax return for 1958, Pearl deducted $82,500 for "cost of borrowing U.S. Treasury Bonds" and in his income tax return for 1959 deducted $82,500 with this same explanation.

Respondent in his notices of deficiency disallowed the deductions claimed as interest paid to CF&L during 1955 and 1956 and the deductions claimed in 1957, 1958, and 1959 as cost of borrowing Treasury bonds and premiums paid for borrowing United States Treasury bonds with the explanation that the amounts were not deductible under any provision of the Internal Revenue Code of 1954.

The parties have agreed that if the interest deductions claimed by each petitioner for 1955 and 1956 are not allowed, each petitioner's taxable income for the years 1956 and 1957 should be reduced by the amounts reported by him as long-term capital gains in those years as follows:

Petitioner	1956	1957
Lewis	$32,500.00	$36,250.00
Furst	45,500.00	45,312.50
Pearl	32,500.00	36,250.00

The parties have agreed that if the deductions claimed for cost of borrowing United States Treasury bonds by each petitioner in 1957, 1958, and 1959 are not allowed, each petitioner's taxable income for the years 1957, 1958, and 1959 should be reduced by the amounts reported by him as interest income received on the 1½ percent notes in those years, as follows:

Petitioner	1957	1958	1959
Lewis	$22,250.00	$45,000	$45,000
Furst	36,000.00	60,000	60,000
Pearl	17,950.82	45,000	45,000

OPINION.

The facts with respect to the claimed interest deduction for 1955 and 1956 in each of these consolidated cases are in all material respects the same as the facts in *Perry A. Nichols*, 37 T.C. 772 (1962) on appeal (C.A. 5, February 15, 1962). In that case we held that there was no actual purchase of Government securities, that the petitioner's loans from CF&L were wholly lacking in substance since CF&L had no funds to lend and, therefore, no payment was made of "interest" on "indebtedness" to CF&L within the meaning of section 163 of the Internal Revenue Code of 1954.[2]

In the instant case, Livingstone directed the simultaneous purchase and sale of large amounts of Government notes. There was no actual purchase of Government notes; merely a purchase and offsetting sale of the same notes on the same day. CF&L was in no position to make loans of the magnitude required, and, in fact, the evidence clearly shows that the funds used to pay for the notes ostensibly purchased were generated by the simultaneous sale of the same notes.

Perry A. Nichols, supra, is controlling and dispositive of the claimed interest deductions in 1955 and 1956. The transactions here described were similarly lacking in substance and were shams which can have no effect for tax purposes. *Eli D. Goodstein*, 30 T.C. 1178 (1958), affd 267 F. 2d 127 (C.A. 1, 1949); *George C. Lynch*, 31 T.C. 990 (1959), affd. 273 F. 2d 867 (C.A. 2, 1959); *Leslie Julian*, 31 T.C. 998 (1959), aff'd. 273 F. 2d 867 (C.A. 2, 1959); and *Becker* v. *Commissioner*, 277 F. 2d 146 (C.A. 2, 1960), affirming on this issue a Memorandum Opinion of this Court.

Petitioners contend that since CF&L did not have sufficient funds to loan to petitioners to purchase the notes,

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[2] Sec. 163, Interest.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

it used a conventional method to finance the transaction, that of the short sale. In effect, petitioners argue that the simultaneous sale by CF&L of the notes purchased from Salomon was a short sale. Their interpretation of the facts indicates that CF&L borrowed petitioners' notes in order to effect a short sale. The evidence of record does not support this contention. There is no evidence of a short sale by CF&L on November 22, 1955, or on March 22, 1956. The only evidence bearing on this issue is that which points to a simultaneous sale of the securities purchased on those dates. CF&L did not purchase securities to close out or cover the transactions, but merely through bookkeeping entries accounted to petitioners for the proceeds of the purported loan.

Petitioners further contend that their purpose in entering these transactions was to make a profit on the rise in prices of the 2⅞ percent United States Treasury notes. Petitioners offer no support for their purported belief that there might be a substantial increase in the prices of the notes. See *Egbert J. Miles*, 31 T.C. 1001 (1959). They also argue that the possibility of a rollover or the opportunity to exchange their notes of a lesser interest-paying face for notes of a higher interest value indicates that this was a profit-seeking transaction. There is no evidence to show any reasonable basis for petitioners to believe that any economic gain could result to them from these transactions aside from the tax benefit they hoped to obtain. There was nothing of substance to be gained by petitioners from the entire transaction other than a tax deduction. *Cf. Knetsch* v. *United States*, 364 U.S. 361 (1960). However, even if some reasonable expectation of an economic gain had existed, this fact would not cause any real indebtedness by petitioners to CF&L to exist on which interest was paid. *Cf. Rubin* v. *United States*, 304 F. 2d 766 (C.A. 7, 1962).

Petitioners contend that if the amounts claimed by them as interest paid for 1955 and 1956 are not deductible, they should be allowed to deduct in 1956 and 1957 their out-of-pocket losses which occurred on the conclusion of the transactions of those years. The out-of-pocket losses or

expenses resulted from the difference in the amount each petitioner paid to CF&L and the amount each received from Livingstone.

Petitioners first contend that the net out-of-pocket losses or expenses are deductible as an ordinary loss on a transaction entered into for profit, under section 165(c)(2) of the Internal Revenue Code of 1954.[3]

Petitioners argue that they expected to make an after-tax profit on these transactions and that, therefore, the transactions were entered into for profit. The evidence does not support petitioners' contention. The facts show that the only profit petitioners could reasonably expect was in tax benefit. In *Eli D. Goodstein, supra* (30 T.C. 1178, 1192-1193) we stated:

> • • • Since the petitioner did not intend to purchase and did not purchase any Treasury notes, it cannot be said that there was a transaction entered into for profit within the meaning of section 23(e) of the Internal Revenue Code of 1939. [now section 165(c) of the Internal Revenue Code of 1954] • • • It is clear that the type of transaction to which the statute refers is one which has substance and in which there is a true motive of deriving a profit. • • •

Our holdings in *Eli D. Goodstein, supra,* and in *Morris R. DeWoskin,* 35 T.C. 356 (1960) that a transaction may

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[3] Sec. 165, Losses.

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

• • •

(c) Limitation on Losses of Individuals.—In the case of an individual, the deduction (a) shall be limited to—

• • •

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

• • •

not be considered as a transaction entered into for profit if the only economic gain to be derived therefrom results from anticipating tax reduction are controlling here.

Petitioners next contend that their out-of-pocket losses are attributable to misrepresentations by Livingstone as to the manner in which the transactions would be carried out. Petitioners contend that such alleged misrepresentations border on fraud and that such fraud is an additional ground for allowing a deduction of the out-of-pocket losses. Had each transaction proceeded precisely in accordance with Livingstone's prospectus, petitioners would have suffered the identical out-of-pocket losses that they did in fact realize. No part of such losses can be said to be due to any alleged misrepresentation of Livingstone. *Cf. Miles* v. *Livingstone*, 301 F. 2d 99 (C.A. 1, 1960).

Petitioners further contend that they are entitled to deductions for out-of-pocket losses as long-term capital losses under the decision in *Becker* v. *Commissioner, supra*, and *MacRae* v. *Commissioner*, 294 F. 2d 56 (C.A. 9, 1961). Although their argument is not spelled out, it would necessarily involve section 1234 of the Internal Revenue Code of 1954[4] (the predecessor section 117(g)(2) of the 1939 Code was in issue in Becker and MacRae).

Section 1234 is clearly inapplicable to petitioners' out-of-pocket losses. Here there was no loss attributable to the sale or exchange of an option, nor was there a loss attributable to the failure to exercise an option. In both the taxable years 1956 and 1957 petitioners exercised their options with Livingstone. We hold that petitioners are not entitled to deductions in 1956 and 1957 for their out-

[4] Sec. 1234. Options To Buy Or Sell.

(a) Treatment of Gain or Loss.—Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

of-pocket losses on the transactions with Livingstone in 1955 and 1956.

The final question presented here is whether petitioners are entitled to deductions in the taxable years 1957, 1958, and 1959 for amounts claimed as a premium paid Livingstone for borrowing United States Treasury 2¾ percent bonds in connection with the alleged short sale of these bonds in 1957 and for payments of interest in 1957, 1958, and 1959 in connection with carrying a short position in these bonds.

Petitioners' position with respect to the claimed deductions for premiums paid and costs of borrowing bonds is that they made a purchase of United States Treasury 1½ percent notes in 1957 and at the same time made a short sale of United States Treasury 2¾ percent bonds using the 1½ percent notes as collateral for the loan from Livingstone of the 2¾ percent bonds sold short. They argue that payments to Livingstone of a premium for the loan of the 2¾ percent bonds and the annual interest payments on the short sale are deductible under Section 212 of the Internal Revenue Code of 1954.[5]

Respondent replies that petitioners' dealings with Livingstone were formulated and executed solely with reference to tax-saving purposes, were entirely without substance, and should be disregarded for Federal income tax purposes. Respondent denies that in fact a short position was ever held and that securities were ever borrowed.

We agree with respondent's contention. On May 7, 1957, Salomon confirmed the purchase of $3,000,000 in United States Treasury 2¾ percent bonds from Lewis at a total price of $2,922,105.98. The confirmation slip indicates that this amount would be paid on the following day in New York at Childs. On the same day, May 7, 1957, Living-

[5] Sec. 212, Expenses For Production Of Income.
In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
(1) for the production or collection of income;

stone placed an order with Childs for the purchase by it from Childs of $3,000,000 United States Treasury 2¾ percent bonds and their delivery against payment to Salomon for the account of Lewis. As a result of this simultaneous transaction, the short sale by Lewis of the 2¾ percent bonds was immediately canceled by the purchase of the identical bonds from another broker. Lewis' account with Salomon indicates that his credit balance resulting from the sale of the bonds was cleared on the following day by the delivery to Salomon of the identical bonds. No proof has been offered that Livingstone owned bonds of this kind in the amounts which he could loan Lewis or that Livingstone possessed funds in sufficient amount to purchase such bonds and lend them to petitioners. Nor is there any evidence that he did lend Lewis these bonds. Thus, the record indicates that Lewis never borrowed securities from Livingstone and that Lewis did not maintain a short position with regard to these bonds. We conclude that these transactions considered as a whole, had no independent economic or business purpose apart from anticipated tax benefits and were wholly without substance. *Eli D. Goodstein, supra. Cf. Empire Press, Inc.*, 35 T.C. 136 (1960); *Egbert J. Miles, supra; MacRae* v. *Commissioner, supra;* and *Perry A. Nichols, supra.*

Petitioners contend that the record demonstrates that they purchased the 1½ percent Treasury notes in 1957 and that there is nothing in the record to show that these notes were disposed of during the period here involved. The record does not support petitioners' contention. There is no evidence to show that these bonds were ever actually purchased by petitioners. However, even if petitioners had actually purchased the 1½ percent notes, they would not be entitled to deduct costs of maintaining a short position in 2¾ percent bonds which they had not in fact borrowed. We sustain respondent in his disallowance of the deductions claimed by petitioners as premiums paid and costs of borrowing United States Treasury bonds in the years 1957, 1958, and 1959.

Decision will be entered under Rule 50.

IN THE

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

No. 14274 SEPTEMBER TERM, 1963 JANUARY SESSION, 1964

LOUIS H. LEWIS and ANNETTE LEWIS; Estate of HYMAN FURST, Deceased, by LOUIS H. LEWIS, Executor; and SAMUEL PEARL and MARY PEARL,
Petitioners.

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decisions of the Tax Court of the United States.

March 2, 1964

Before HASTINGS, *Chief Judge*, and KNOCH and KILEY, *Circuit Judges*.

HASTINGS, *Chief Judge*. Taxpayers[1] petition for review of eight decisions of the Tax Court of the United States determining deficiencies in the tax due from them in the total amount of $285,306.98. T. C. Memo. 1962-306. The

[1] The taxpayer-petitioners are Louis H. Lewis and Annette Lewis; Estate of Hyman Furst, deceased, by Louis H. Lewis, Executor; and Samuel Pearl and Mary Pearl. Annette Lewis is the wife of Louis H. Lewis and Mary Pearl is the wife of Samuel Pearl. The wives did not participate actively in the transactions under scrutiny and are parties solely because joint returns were filed in the taxable years. Hyman Furst died in 1961 and his estate is represented by Louis H. Lewis, Executor.

cases were consolidated for trial and for the purposes of this review.

The facts in each of the cases are substantially identical, except for the amounts involved. On this review it shall be sufficient to consider the facts referring to Louis H. Lewis.

We are concerned with the tax years 1955 through 1959.

The decisions of the Tax Court were based on its conclusions that:

> (1) certain amounts claimed as interest deductions in 1955 and 1956 arising out of loans incurred to purchase United States Government securities were not deductible;
>
> (2) taxpayers' out-of-pocket expenses or losses incurred in such securities transactions were not deductible; and
>
> (3) amounts claimed as expenses of borrowing securities in 1957 and of carrying a short position during 1957, 1958 and 1959 were not deductible.

On this review, no appeal is taken from that portion of the Tax Court's decisions disallowing the deductions claimed for interest expenses. This holding appears to be well established by an unbroken line of decisions. Regardless of a taxpayer's motives, where a paper transaction lacks substance and no genuine indebtedness is created resulting in a bona fide debtor-creditor relationship, no interest can be said to have been paid for the use or forbearance of money actually loaned and no interest expense deduction may flow therefrom. *Bridges* v. *C. I. R.*, 4 Cir., 325 F. 2d 180 (1963); *Salley* v. *C. I. R.*, 5 Cir., 319 F. 2d 847 (1963); *Nichols* v. *C. I. R.*, 5 Cir., 314 F. 2d 337 (1963); *Rubin* v. *United States*, 7 Cir., 304 F. 2d 766 (1962); *MacRae* v. *C. I. R.*, 9 Cir., 294 F. 2d 56 (1961), cert. denied, 368 U. S. 955; *Kaye* v. *C. I. R.*, 9 Cir., 287 F. 2d 40 (1961); *Becker* v. *C. I. R.*, 2 Cir., 277 F. 2d 146 (1960); *Lynch* v. *C. I. R.*, 2 Cir., 273 F. 2d 867 (1959); *Goodstein* v. *C. I. R.*,

1 Cir., 267 F. 2d 127 (1959); *Broome* v. *United States*, Ct. Cl., 170 F. Supp. 613 (1959). Cf., *Knetsch* v. *United States*, 364 U. S. 361 (1960; *Deputy* v. *DuPont*, 308 U. S. 488 (1940); *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

This review presents another variant of the plans devised by M. Eli Livingstone, a Boston broker, several of which were the subject of some of the foregoing decisions. They have generally been concerned with a plan for reducing income taxes through the device of claiming deductions for alleged payment of interest on loans to finance the purchase of Government securities.

Two plans are involved in the instant case. The Tax Court's findings of fact and opinion are not officially reported. This requires a summary statement of the facts in each situation.

THE NOVEMBER, 1955 TRANSACTION.

On November 22, 1955, Lewis directed Livingstone to purchase for his account $1,000,000 face value United States Treasury 2⅞% notes due March 15, 1957, with interest coupons due March 15 and September 15, 1956, detached.

Livingstone confirmed the purchase at a price of 97½, a total of $975,000. Livingstone also granted Lewis an irrevocable option, or "put," to sell the notes back to Livingstone on September 15, 1956 at a price of 100¾. There was no charge for the "put."

At the same time, Livingstone sent Lewis a note for $975,000 payable to Corporate Finance & Loan Corporation (CF&L),[2] letters of instructions for Lewis' signature and Livingstone's check to Lewis for $32,500. This amount was paid to Lewis as security for the option granted him to sell the notes to Livingstone at the agreed price. Lewis retained the $32,500 and it was accounted for at the close of the transaction in 1956, when it was charged to his

[2] CF&L was a Massachusetts corporation. It received substantially all its business from Livingstone and paid him for his services.

account. Livingstone acted as principal in the sale of the bonds and charged no commission.

Lewis was requested to sign the note and letters of instruction and return them to Livingstone, together with Lewis' check for $40,218.75 payable to CF&L. The check was purportedly a prepayment of interest. With the letter prepared for him by Livingstone, Lewis directed him to deliver the Treasury notes against payment of $975,000 to CF&L, and directed CF&L to pay this sum and receive the notes from Livingstone.

Lewis signed the note prepared by Livingstone. It was dated November 22, 1955, calling for the payment in one year of $975,000 to CF&L, with interest at 4⅛% ($40,218.75) prepaid. It recited that Lewis had deposited the $1,000,000 Treasury 2⅞% notes as collateral with CF&L. There was no provision for reimbursement of interest in event of prepayment of principal.

The transaction was recorded on the CF&L books with a debit entry of $975,000 to "Notes Receivable, Clients," and a credit entry in the same amount to "Loans Receivable, Livingstone & Co."

Livingstone placed a buy order with another dealer in Government securities, designated for Lewis' account, directing delivery of the $1,000,000 Treasury 2⅞% notes due March 15, 1957, to a New York bank against payment. He instructed the bank to receive the securities against payment. He also placed another order directing a sale for the account of CF&L, and the receipt of the $1,000,000 2⅞% notes from the bank against payment. He instructed the bank to deliver the securities to the dealer against payment. He paid the dealer the differential between the purchase and sale prices. The bank, which debited and credited Livingstone's account in the amounts of the sale and purchase prices, was paid a clearing fee for its services.

The Treasury notes never left the office of the dealer. Neither Lewis, Livingstone nor CF&L ever acquired actual

physical possession of them. A confirmation slip sent by the dealer mentioned Lewis by name only, at Livingstone's request.

Lewis issued a check dated December 1, 1955 for $40,218.75, payable to CF&L. This was reflected as payment of interest on the $975,000 note.

The next year, on September 5, 1956, Livingstone sent Lewis a letter enclosing documents necessary to close out the transaction. A confirmation slip dated September 15, 1956, from Livingstone to Lewis showed that Livingstone had purchased from him the $1,000,000 Treasury notes at 100¾. Lewis directed CF&L to deliver the same amount of such securities to Livingstone against payment of $975,000 by Livingstone. CF&L was directed to use the proceeds to discharge Lewis' outstanding loan.

Livingstone issued a statement to Lewis showing a credit of $1,007,500 for the sale of the notes and debits of $975,000 and $32,500, leaving a zero balance. CF&L made entries on its books reflecting receipt of $975,000 due on Lewis' loan and sent him his one-year note for $975,000, marked as paid.

The net out-of-pocket expense to Lewis resulting from this transaction was $7,718.75—the difference between the amount purportedly prepaid as interest ($40,218.75) and the amount received from Livingstone as security for the "put" ($32,500).

At the same time, similar transactions were entered into by the other taxpayers. On March 22, 1956, the taxpayers each entered into a second and similar transaction planned by Livingstone. It was closed out on March 5, 1957. The net out-of-pocket expense to Lewis on this plan was $7,772.93, computed on the same basis as the year before.

THE MAY, 1957 TRANSACTION.

Livingstone proposed this plan to Lewis in a letter of January 4, 1957, involving a short sale of Treasury bonds and the purchase of Treasury notes.

On May 7, 1957, Lewis instructed Livingstone to sell short for his account $3,000,000 United States Treasury 2¾% bonds due September 15, 1961, and to sell to him $3,000,000 United States Treasury 1½% notes due October 1, 1961.

Livingstone thereupon placed an order with Salomon (a Government securities dealer), designated for Lewis' account, for the sale to Salomon of $3,000,000 Treasury 2¾% bonds due September 15, 1961; delivery of such bonds to be made the next day to Childs (another dealer). Lewis directed Livingstone Securities Corporation (LSC), an entity controlled by Livingstone, to deliver the bonds to Salomon against payment to Salomon of $2,922,105.98, and directed Salomon to receive the bonds from LSC.

On May 6, 1957, LSC sold to Lewis, as agent for another, $3,000,000 United States Treasury 1½% notes due October 1, 1961, for a total price of $2,753,299.18, including interest. No commission was charged on this transaction.

At the same time, LSC placed an order with Childs for purchase by it of $3,000,000 Treasury 2¾% bonds due September 15, 1961, with delivery to Salomon for Lewis' account, and directed Salomon to receive these bonds from Childs and pay $2,922,105.98.

The following day, on May 8, 1957, Lewis acknowledged receipt of the Treasury 2¾% bonds purchased from Childs and simultaneously sold short to Salomon. He further agreed to deposit with Livingstone the $3,000,000 Treasury 1½% notes and $168,806.80 in cash. $168,806.80 represented the excess of the proceeds from the short sale of the 2¾% bonds over the amount paid for the 1½% notes. This sum was to be used, along with coupon interest on the 1½% notes, to reimburse Livingstone for coupon interest due Livingstone on the 2¾% bonds Lewis had allegedly borrowed to cover his short sale.

Lewis further agreed to pay Livingstone $33,750 as a premium for the alleged loan of the 2¾% bonds. Livingstone acknowledged receipt of the 1½% notes and $168,-

806.80 cash to be held as collateral security for return of the borrowed 2¾% bonds.

On May 21, 1957, LSC notified Lewis that in his purchase of the 1½% notes and the delivery of the 2¾% bonds, it had acted as agent for Livingstone and that Lewis' contract was solely with Livingstone.

In 1957, Lewis issued four checks to Livingstone, each for $8,437.50, or a total of $33,750, in payment of the premium hereinabove referred to.

By letter of January 15, 1958, Livingstone advised Lewis that in 1957 Lewis had been charged an expense of $29,144.02 in connection with borrowing the 2¾% bonds and had paid a premium of $33,750 for borrowing these bonds.

In January, 1959 and January, 1960, Livingstone further advised Lewis that he had been charged a coupon expense of $82,500 in each of the years 1958 and 1959 in connection with the borrowed bonds.

The other taxpayers entered into similar transactions in the same years.

In their tax returns for 1955 and 1956, each of the taxpayers deducted the amounts allegedly paid as interest to CF&L to borrow funds necessary to purchase the Treasury 2⅞% bonds in the November, 1955 transaction.

In their tax returns for 1957, 1958 and 1959, each of the taxpayers deducted the amounts claimed as expenses in connection with the short sale in the May, 1957 transaction.

The Commissioner disallowed both the claimed interest deductions for 1955 and 1956, and the deductions claimed for the cost of borrowing Treasury bonds in 1957, 1958 and 1959.

The Tax Court sustained the Commissioner's determination. It further held that the out-of-pocket expenses or losses incurred in the November, 1955 transaction were not deductible either as expenses or as capital losses.

I.

Taxpayers contend that their out-of-pocket expenses or losses incurred in the November, 1955 transaction are deductible in full from gross income under the Internal Revenue Code of 1954.

They first argue that such expenses are deductible under the provisions of § 165(c)(2) of the 1954 Code[3] as a loss on a transaction entered into for profit because petitioner reasonably expected to receive an after-tax profit on the transaction.

The Tax Court found that the "facts show that the only profit petitioners could reasonably expect was in tax benefit." This tax benefit could only result in an after-tax profit on the transactions under scrutiny. Here they sought to do this by creating a fictitious interest deduction. In that they have failed. They now would seek reward for expenses incurred in achieving this failure. We find no support for holding that such a transaction is one "entered into for profit" within the meaning of the statute.

As indicated in *Rubin* v. *United States*, 7 Cir., 304 F. 2d 766, 770 (1962), and most of the other cases cited above in support of the denial of the interest deduction, the transaction was without substance and was a paper transaction amounting only to a "financial round robin."

The Tax Court held in *Eli D. Goodstein*, 30 T.C. 1178, 1192-1193 (1958), affirmed 267 F. 2d 127, "Since the petitioner did not intend to purchase and did not purchase any Treasury notes, it cannot be said that there was a transaction entered into for profit within the meaning of section 23(e) of the Internal Revenue Code of 1939. [§ 165(c) of the 1954 Code]. * * * It is clear that the type of transaction in which the statute refers to is one which has substance and in which there is a true motive of deriving a profit." We agree.

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[3] 26 U. S. C. A. § 165 provides:

"§ 165. Losses

* * *

"(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * *

"(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *."

In the alternative, taxpayers argue that the out-of-pocket expenses in the November, 1955 transaction are deductible as professional fees. That is, the payments made to Livingstone were for services rendered, under the provisions of § 212 of the 1954 Code.[4]

As we have held, the transaction was without substance. Livingstone's plan was supposed to diminish taxpayers' tax liability. The motivating factor causing taxpayers to enter into the transaction was to secure large interest deductions. It had no business origin. The "professional fee" paid to Livingstone did not arise in connection with taxpayers' profit-seeking activities. What taxpayers sought to gain was a consequence resulting in a lower tax.

As the court said in *MacRae* v. *C. I. R.*, 9 Cir., 294 F. 2d 56 (1961), at 59, 60, "To allow such out-of-pocket expenditure as a loss incurred in a transaction entered into for profit would be inconsistent with our affirmance of the Tax Court holding that the transactions here involved were not in substance purchases of securities with borrowed money entered into for profit, but were in reality attempts to stimulate such security transactions for the purpose of artificially creating tax deductions." We agree.

We hold that the expense paid to Livingstone, under the facts of this case, finds no support in the statutory scheme. To rule otherwise would be to read into the statute a meaning that would avoid the purpose inherent in granting deductions from gross income.

II

Since we hold that taxpayers' out-of-pocket expenses incurred in the November, 1955 transaction are not deductible in full on the grounds presented in the preceding sec-

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[4] 26 U. S. C. A. § 212 provides:

"§ 212. Expenses for production of income

"In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax."

tion of this opinion, taxpayers contend that such losses are deductible as long term capital losses. They rely on the holdings of the Second Circuit in *Lynch* v. *C. I. R.*, 273 F. 2d 867 (1959) and *Becker* v. *C. I. R.*, 277 F. 2d 146 (1960); the Ninth Circuit in *MacRae* v. *C. I. R.*, 294 F. 2d 56 (1961); and dicta by the First Circuit in *Goodstein* v. *C. I. R.*, 267 F. 2d 127 (1959). We respectfully disagree.

The claim for such a deduction is necessarily based on the provisions of § 1234 of the 1954 Code.[5] The equivalent and predecessor section of the 1939 Code, § 117(g)(2), was in issue in *Becker* and *MacRae*.

The only applicable provision in § 1234 is that referring to a "loss attributable to failure to exercise, a privilege or option to buy or sell property." What were the options, if any, granted by Livingstone to Lewis?

One option was the "put" granted to Lewis to sell the notes back to Livingstone on September 15, 1956 at a price of 100¾. The statute is not applicable to this option for the reason that it was exercised by Lewis according to the terms of the paper plan transaction. Thus, by selling the notes to Livingstone for $1,007,500, everything was equalized except the difference of $7,718.75 which represented Livingstone's fee for the scheme.

Apparently, the option Lewis had in mind and the one considered in *Becker* and *MacRae*, was the option to terminate the transaction at any time by having Livingstone deliver the Government notes to Lewis, thereby halting the

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[5] 26 U. S. C. A. § 1234 (1958) ed. provides:

"§ 1234. Options to buy or sell

"(a) Treatment of gain or loss.—Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

"(b) Special rule for loss attributable to failure to exercise option.—For purposes of subsection (a), if loss is attributable to failure to exercise a privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired.

* * *"

running of interest. We fail to see that the right to terminate the loan can be considered an "option to buy or sell property." Further, there was no showing that any prepayment of the loan would result in any partial refund of the prepaid interest.

Finally, we believe the fallacy in the "option" argument is the same fatal weakness that caused the courts to deny the "interest" payment or the out-of-pocket expense as an ordinary deduction for loss or business expense. That fallacy is the uniform holding that the whole scheme was a sham and had no substance as a business transaction entered into for profit or for the production of income. Having held that there was no intention on the part of Lewis to purchase or sell securities but only to effect a tax saving, it likewise must be considered a sham insofar as granting any such "option" as taxpayers now assert.

Although taxpayers contend there was an additional profit seeking motive, the Tax Court found to the contrary from the evidence before it. We find there is substantial evidence in the record to support this finding and that it should not be set aside.

We hold that the out-of-pocket expense may not be deducted by taxpayers as a long term capital loss in their returns for the two years involved.

III.

The final question presented concerns the May, 1957 transaction. Taxpayers claim deductions for premiums paid for borrowing bonds and yearly expense incurred to maintain their short position. This applies to the taxable years 1957, 1958 and 1959.

Lewis claims he made a purchase of Government 1½% Treasury notes in 1957 and at the same time made a short sale of Government 2¾% Treasury bonds, using the 1½% notes as collateral for the loan from Livin one of the 2¾% bonds sold short. We have hereinbefore set out this transaction in some detail.

Taxpayers argue that the premium of $33,750 paid to Livingstone by Lewis in 1957 and the interest payments on the short sale are deductible under § 212 of the 1954 Code, *supra* at fn. 4.

We think the Tax Court correctly decided this issue when it stated:

"* * * On May 7, 1957, Salomon confirmed the purchase of $3,000,000 in United States Treasury 2¾ percent bonds from Lewis at a total price of $2,922,105.98. The confirmation slip indicates that this amount would be paid on the following day in New York at Childs. On the same day, May 7, 1957, Livingstone placed an order with Childs for the purchase by it from Childs of $3,000,000 United States Treasury 2¾ percent bonds and their delivery against payment to Salomon for the account of Lewis. As a result of this simultaneous transaction, the short sale by Lewis of the 2¾ percent bonds was immediately canceled by the purchase of the identical bonds from another broker. Lewis' account with Salomon indicates that his credit balance resulting from the sale of the bonds was cleared on the following day by the delivery to Salomon of the identical bonds. No proof has been offered that Livingstone owned bonds of this kind in the amounts which he could loan Lewis or that Livingstone possessed funds in sufficient amount to purchase such bonds and lend them to petitioners. Nor is there any evidence that he did lend Lewis these bonds. Thus, the record indicates that Lewis never borrowed securities from Livingstone and that Lewis did not maintain a short position with regard to these bonds. We conclude that these transactions considered as a whole, had no independent economic or business purpose apart from anticipated tax benefits and were wholly without substance. * * *

"Petitioners contend that the record demonstrates that they purchased the 1½ percent Treasury notes in 1957 and that there is nothing in the record to show that these notes were disposed of during the period

here involved. The record does not support petitioners' contention. There is no evidence to show that these bonds were ever actually purchased by petitioners. However, even if petitioners had actually purchased the 1½ percent notes, they would not be entitled to deduct costs of maintaining a short position in 2¾ percent bonds which they had not in fact, borrowed. * * *"

This position finds support in the rationale of *Rubin* v. *United States*, 7 Cir., 304 F. 2d 766 (1962) and other cases earlier cited in support of the denial of the "interest" deduction. This plan devised by Livingstone was a legitimate transaction. However, as we quoted the Tax Court in *MacRae*, 34 T. C. at 26, in our opinion in *Rubin*, 304 F. 2d at 770: "The steps taken, each in itself a legitimate commercial operation, were here each mirror images, and add up to zero. * * * The choice of the more complicated and involved method of doing nothing had no purpose, save the erection of the facade upon which petitioners now seek to rely."

The Tax Court properly found the facts and its finding is amply supported by the record.

Taxpayers contend that the transaction was real because Lewis would have made a cash profit if he had elected to cover his short sale on September 15, 1959. We answered that in *Rubin*, 304 F. 2d at 770, where Judge Swygert, speaking for our court, aptly said, "Due to the fluctuations in the market it was likely that taxpayer would either make or lose money on the transaction; but this was incidental to the chimerical character of the transaction."

We hold that the Tax Court correctly decided that taxpayers were not entitled to deduct the expense of maintaining their short interest in the May, 1957 transaction in the tax years 1957, 1958 and 1959.

For the foregoing reasons, the decisions of the Tax Court under review in this proceeding are held to be correct and in all respect are now affirmed.

AFFIRMED.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Monday, March 2, 1964

Before

Hon. John S. Hastings, Chief Judge
Hon. Win G. Knoch, Circuit Judge
Hon. Roger J. Kiley, Circuit Judge

LOUIS H. LEWIS and ANNETTE LEWIS; Estate of HYMAN FURST, Deceased, by LOUIS H. LEWIS, Executor; and SAMUEL PEARL and MARY PEARL,

Petitioners,

v.

No. 14274

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decisions of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decisions of the Tax Court of the United States entered in this cause on April 5, 1963, be, and the same are hereby, Affirmed, in accordance with the opinion of this Court filed this day.